United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

77-7183, -7186

United States Court of Appeals

FOR THE SECOND CIRCUIT

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Plaintiffs-Appellants,

—against—

TOUCHE ROSS & Co.,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

TRUSTEE'S REPLY BRIEF

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OCT 25 1977

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United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos. 77-7183 and 77-7186

EDWARD S. REDINGTON, as Trustee for the liquidation of the business of Weis Securities, Inc., and SECURITIES INVESTOR PROTECTION CORPORATION,

Plaintiffs-Appellants,

—against—

TOUCHE ROSS & Co.,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

TRUSTEE'S REPLY BRIEF

Preliminary Statement

Plaintiff Edward S. Redington, Trustee for the liquidation of the business of Weis Securities, Inc. (the "Trustee"), submits this brief in reply to the 104 page Answering Brief of defendant Touche Ross & Co. The Reply Brief of the Trustee's co-plaintiff, the Securities Investor Protection Corporation ("SIPC"), is incorporated herein by reference.

Before turning to the Argument, the attention of the Court must be called to Touche Ross' rather extravagant characterizations of the plaintiffs' State court remedies and the status of their State court action.

Touche Ross continually recites that this case involves State causes of action and that plaintiffs should be pursu-

ing their State court action rather than employing the "well-worn tactic" (the advantages of which are nowhere explained) of seeking to "federalize" their claim. (Touche Ross Brief at 2-3, 21, 48-49.) In fact, the "State law remedy" may be no remedy at all.

Touche Ross' position below and in the State court has been that plaintiff SIPC can state no claim for relief of any kind under State law and that the Trustee can state a State law claim for relief only for negligence and not for breach of contract, breach of warranty or negligence *per se* based on Touche Ross' failure to comply with Rule 17a-5. (127a-128a.) Moreover, Touche Ross does not appear to concede that either the Trustee (as bailee for customers) or customers themselves can assert a negligence claim against an accountant under State law. (See Touche Ross Brief at 56-59.) Thus, if no private right of action is recognized under Section 17 for an accounting firm's failure to adhere to Rule 17a-5, it cannot be presupposed that either these or any other potential plaintiffs will have an effective remedy for even the most reckless of certifications.

Touche Ross also places unwarranted emphasis upon the proceedings to date in the plaintiffs' State court action. (Touche Ross Brief at 2-3, 11, 101.) The State court action was commenced, as a precautionary measure, ten months before this one only in the most technical, ephemeral sense: a summons without complaint was served. By letter agreements among the parties, no complaint was immediately served or demanded; in fact, the complaint in the State court action was ultimately served only after the complaint in this action had been filed.

Thereafter plaintiffs did everything in their power, including moving to stay their own action, to keep the State court action on the "back burner" in favor of this, the more comprehensive, action. Despite these efforts they were each ordered to respond to one set of interrogatories some two or three weeks after filing their briefs in this Court. They are now in the process of preparing final

answers. Those interrogatories constitute the sum total of all the "progress" that has been made in the State court action to date. Plaintiffs have repeatedly told defendant's attorneys, and stated in open court below, that they would agree to stay or discontinue their State court action once jurisdiction over their claims is established in the federal courts.

ARGUMENT

I.

A Private Right of Action Should Be Implied Under Section 17 in Favor of a SIPA Trustee.

A. Touche Ross' Arguments for Denying a Private Right of Action Are Too Facile.

1. *It Is No Answer to Point to the Remedies for Investors in Section 18(a) of the Exchange Act; Section 17 Protects a Broker's Customers, Not an Issuer's Investors.*

Touche Ross places primary reliance on the rights given investors to sue issuers for false statements in "reports" under Section 18(a) as an indication that Congress intended not to permit suits by customers protected by the different reporting system required of brokers. (Touche Ross Brief at 20-31.)

As pointed out by SIPC and the SEC, the purpose of Section 18(a) is to define the elements of a cause of action for a certain class of people protected by certain sections of the Exchange Act—investors in companies which file reports. It may be possible to divine from such a provision an intent to deprive members of that class of a right to recover damages in other than the enumerated circumstances. The Section 13 cases relied on by Touche Ross say just that and no more. It would be a far different thing to divine from such a provision an intent to deny a right of action to a class of people protected by different sections of the Exchange Act—the customers represented here by SIPC and the Trustee.

Section 18 is not the sole jurisdictional provision in the Exchange Act. Section 27 provides for exclusive federal court jurisdiction over any action to enforce a liability or duty created by the Exchange Act or the rules and regulations thereunder. Section 18(a) has never been read to forbid damage actions by persons such as customers who are protected by provisions other than those which protect purchasers and sellers of an issuer's securities. *See, e.g., J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964); *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973); *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

2. *It Is No Answer to Point to Criminal Penalty and Injunctive Relief Provisions; This Action Seeks to Recover for Harm, Not to Prevent It.*

It cannot reasonably be presumed that Congress intended to preempt private rights of action for damages by vesting certain enforcement powers in the SEC. The SEC itself supports this appeal because it recognizes that the entire enforcement machinery collapses if auditors fail to expose material inadequacies in a broker's record-keeping and fail to uncover the skeletons in its financial closets. The SEC regards private actions such as this one as a necessary supplement to its own enforcement proceedings. A private right of action must be implied both as a deterrent and to provide compensation for damage that could not be prevented by the early warning system.

Touche Ross' reliance on cases such as *SIPC* v. *Barbour*, 421 U.S. 412 (1975), and *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers*, 414 U.S. 453 (1974), is misplaced. Those cases were not only decided under statutes having no general jurisdictional grants for private actions comparable to Section 27 of the Exchange Act, they involved attempts by private parties to secure prospective relief when the right to seek such relief had explicitly been entrusted to administrative agencies or the Attorney General of the United States. The analogy

here would be a suit by a Weis customer to enjoin Weis from conducting a brokerage business or to suspend Touche Ross as an auditor of brokerage firms because of its failure to comply with Rule 17a-5.

This action simply involves the recovery of damages from a private party. It is an action under Section 27 to enforce duties and liabilities created by SEC Rule 17a-5. The pertinent authority is *J.I. Case Co.* v. *Borak, supra*—a case which both the Supreme Court and this Court have distinguished from the *Barbour* situation on grounds equally applicable to this appeal. *See SIPC* v. *Barbour, supra,* 421 U.S. at 424; *Abrahamson* v. *Fleschner,* [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,889 at 91,282 n.19 (2d Cir. 1977), *rehearing granted* (April 15, 1977).

It is far less radical to imply a private right of action against an accounting firm under Sections 17 and 27 than it is to imply a right of action against a self-regulatory body such as a securities exchange under Sections 6 and 27. Yet customers have had an implied right of action against securities exchanges in this circuit since 1944. *Arneil* v. *Ramsey,* 550 F.2d 774 (2d Cir. 1977); *Baird* v. *Franklin,* 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944).

3. *It Is No Answer to Point to State Court Remedies; Those Remedies May Well Be Limited or Non-Existent.*

As noted at page 2, Touche Ross' position is that SIPC can state no claim for relief against it under State law and that the Trustee can state a claim only for negligence and only on behalf of Weis, not on behalf of Weis' customer-bailors. It is because of the doubt and uncertainty that exists about the ability of customers or their representatives to sue an accounting firm directly for even the most flagrant breaches of its Rule 17a-5 duties under the laws of the various States that a uniform private right of action should be implied under Section 17. It was the desire for uniform and effective relief that led Congress to give the

federal district courts exclusive jurisdiction under Section 27 of the Exchange Act over actions to enforce "any liability or duty created by the Exchange Act or the rules and regulations thereunder."

4. *It Is No Answer to Say That No Duties Are Imposed on Accountants by Rule 17a-5; The Rule Requires Accountants That Make Brokerage House Audits to Certify That They Performed Certain Duties.*

Rule 17a-5 as it existed in 1972 is set forth at pages 1a and 2a of the addendum to the Trustee's original brief. This Rule clearly states specific accounting and auditing procedures which accountants must certify they have conducted in order for the audited reports to be acceptable for filing. The provisions of subsections (g) through (*i*) of the Rule speak in terms of what the accountant, not the broker, must do. To be sure, this Rule imposes no duty on the accountant in the sense that nothing compels an accountant to perform the Rule 17a-5 audit and make the required certifications. But when the accountant undertakes to conduct an audit complying with the Rule, it assumes the duty to do everything that the Rule requires.[1]

Here Touche Ross informed both Weis and the regulatory authorities that it would perform the services contemplated by Rule 17a-5 and certified—in the face of the warnings of potential liability contained in the Rule itself —that it had performed those services. A failure to perform those services resulting in substantial damage should be actionable *per se*. It should not, as Touche Ross would have it, constitute simply one aspect of a vague and ill-defined duty of reasonable care which may not even be actionable in the State courts by or on behalf of those most directly protected by legislation and rule.

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[1] Though leaving the question of accountants' liability under Section 17 open, the Supreme Court seems to have recognized that Rule 17a-5 imposed duties on accountants in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). See *id.* at 188 n.1, 194 n.13.

It is abundantly clear from Rule 17a-5 and Touche Ross' certifications thereunder that accountants assume a "duty" created by Rule 17a-5 when they conduct brokerage house audits; it is equally clear from Section 27 that Congress intended breaches of duty created by SEC rules to be directly actionable in the federal courts. Efficacious remedies for those protected by the Exchange Act should not depend on the vagaries of State common law precedents developed in fields where Congress has never acted.

5. *It Is No Answer to Say That Plaintiffs Have Not Alleged "Scienter"; More "Scienter" Than Should Be Necessary Has Been Alleged.*

Touche Ross argues this appeal as if the plaintiffs had alleged nothing more than negligence. (Touche Ross Brief at 8, 66-67.) This assumption is false. Both plaintiffs specifically allege gross negligence, recklessness and the making of false statements. (Complaint ¶ 28.) The Supreme Court intimated in *Hochfelder* that such allegations might state a cause of action even under Section 10(b) and Rule 10b-5—provisions speaking to fraud and "cunning" schemes and devices to defraud. *See Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 193-94 n.12. *Accord*, *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1304-06 (2d Cir. 1973). In any event, if further allegations of *scienter* were required, the remedy at this early juncture should be to require plaintiffs to replead, not to dismiss the complaint.

Section 17 and the rules and regulations thereunder are not, moreover, anti-fraud provisions. They are customer protection provisions. The accountant assumes a duty to audit a broker in conformity with the requirements of Rule 17a-5; he need not have an intent to defraud to breach that duty and destroy the efficacy of the system for ensuring public protection established by Congress. As with actions based on Rule 14a-9—an SEC rule adopted under a rule-making authority identical to Section 17(a)—this case does not involve the type of rule or statute that led the Supreme Court to require some sort of *scienter* in 10b-5 actions in

Hochfelder. See Gerstle v. *Gamble-Skogmo, Inc., supra,* 478 F.2d at 1299.

B. A SIPA Trustee Can Sue Under Section 17 in the Interests of the Customers of Whose Property It Is a Bailee.

Touche Ross accuses the Trustee of "nonsense" and of "not understand[ing] the law of bailment" when he claims to maintain this action as bailee on behalf of Weis' customers. According to Touche Ross, a bailee cannot maintain an action for the benefit and on behalf of its bailor, but merely "is entitled to sue to vindicate only his own possessory rights, not the rights of the bailor-owner." (Touche Ross Brief at 57). In making its argument, Touche Ross cites no case law, misconceives the full extent of the Trustee's argument, and quibbles with several centuries of common law.

It is true that a bailee's right to sue for injury to the bailment entrusted to him is based on his special possessory interest in it. This is merely a restatement of what a bailee is and a recognition that what makes a bailee an appropriate interested party to prosecute an action on behalf of his bailor is his special possessory interest. The courts have for centuries recognized the right of bailees to represent and requite the interests of bailors as well as their own possessory interests.[2] (See Trustee's Brief at 17.) For example, the Supreme Court clearly indicated such a representative capacity of the bailee in *The Beaconsfield,* 158 U.S. 303, 307 (1895):

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[2] In fact, originally the common law developed so that only the bailee—the party in possession—could enforce claims for injury to the bailed property. It was only later that the bailor was also allowed to vindicate his property interests. O.W. Holmes, The Common Law 164 *et seq.* (1923 ed.); Berger v. 34th Street Garage, Inc., 274 App. Div. 414, 417, 84 N.Y.S.2d 348, 351 (1st Dep't 1948), *appeal denied,* 275 App. Div. 660, 86 N.Y.S.2d 667 (1st Dep't 1949).

> "The Beaconsfield having been sunk in a collision with the Britannia, her master and owner, *as bailees of her cargo,* proceeded against the Britannia for damages done to such cargo. This they had a right to do. *It is perfectly well settled that the carrier is so far the representative of the owner that he may sue in his own name,* either at common law or in admiralty, for a trespass upon or injury to the property carried." (Emphasis added).

Accord Baldwin v. *Hill,* 315 F.2d 738, 742 (6th Cir. 1963) (cited in Trustee's Brief 17) ("With respect to third persons, [a bailee] stands in the place of the owner".)[3]

If the Trustee has "not understood" this basic doctrine of bailment law, he is in good company. Not only the courts cited by the Trustee, but the drafters of the Federal Rules of Civil Procedure share his confusion. Rule 17(a) explicitly provides that:

> "Every action shall be prosecuted in the name of the real party in interest. An executor, administrator, guardian, *bailee,* trustee of an express trust, a party with whom or in whose name a contract has been made for the benefit of another, or a party authorized by statute may sue in his own name *without joining with him the party for whose benefit the action is brought* * * *." (Emphasis added.)

The Committee Note explaining the specific addition in 1966 of bailees to the list of those parties who could bring representative suits clearly recognized the capacity of a bailee to sue on behalf of the bailor:

> "The rule adds to the illustrative list of real parties in interest a bailee—meaning, of course, *a bailee suing on behalf of the bailor* with respect to the property

[3] Touche Ross objects at page 57 of its Brief that *Baldwin* v. *Hill* involved a guest-passenger statute. The case also contains discussion of bailor-bailee rights *vis-à-vis* third parties. The statements of the court in that connection speak for themselves.

> bailed. (When the possessor of property other than the owner sues for an invasion of the possessory interest he is the real party in interest.) The word "bailee" is added primarily to preserve the admiralty practice whereby the owner of a vessel as bailee of the cargo, or the master of the vessel as bailee of both vessel and cargo, sues for damage to either property interest or both. But there is no reason to limit such a provision to maritime situations. The owner of a warehouse in which household furniture is stored is equally entitled to sue on behalf of the numerous owners of the furniture stored." (Emphasis added.)

Touche Ross' unarticulated premise is that two separate and severable interests emanate from a bailment—the bailor's ownership interest on the one hand and the bailee's special possessory interest on the other—and that the parties to the bailment can only bring actions to protect their own interests. Such a premise contradicts three elementary principles of bailment law: (1) either the bailor or bailee can bring an action on the *same* injury to the bailed property, so that a recovery by one is a bar to a subsequent recovery by the other; (2) a bailee can sue for a full recovery beyond any direct harm to it and regardless of any liability it might have to the bailor; and (3) the bailee holds such recovery in trust for the bailor. As the New York Court of Appeals explained in *Rogers* v. *Atlantic, Gulf & Pacific Co.*, 213 N.Y. 246, 258, 107 N.E. 661, 664 (1915):

> "A bailee, though not liable to the bailor, may recover for the wrongful act of a third party resulting in the loss of, or injury to, the subject of the bailment. * * * If the bailee recovers, he holds the recovery as trustee for the bailor. A recovery by either bailor or bailee will bar an action by the other." [4]

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[4] See 5 N.Y. Jur. Bailment §§ 118, 119 where all of the above propositions are laid out in the paragraphs following the phrases

Accord, e.g., Berger v. *34th Street Garage, Inc.*, 274 App. Div. 414, 416-20, 84 N.Y.S. 2d 348, 350-53 (1st Dep't 1948), *appeal denied*, 275 App. Div. 660, 86 N.Y.S. 2d 667 (1st Dep't 1949).

Thus, as bailee of customer property, with special duties to marshal the single and separate fund of customer property, the Trustee may maintain this action on behalf of customers—the intended beneficiaries of Section 17.

C. A SIPA Trustee Can Sue Under Section 17 for Losses Sustained by a Broker as Well as Its Customers.

Touche Ross argues that the Trustee cannot maintain an action based on Rule 17a-5 to recover the losses sustained by Weis as a corporate entity on the theory that *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977), and *Lank* v. *New York Stock Exchange*, 548 F.2d 61 (2d Cir. 1977), deny the right to bring such an action to the parties whose conduct is regulated by rule or statute. As discussed above, however, the portions of Rule 17a-5 under which the Trustee maintains this action are not directed at brokers such as Weis, but deal with the contents of the auditor's certificate and the accounting steps which the accounting firm is required to employ.

Moreover, for the reasons noted in our first brief (at 23-26), Touche Ross far overstates the effect of *Lank*—a case involving a suit against a securities exchange under Section 6—on this Section 17 action against a broker's accountants. The rationale in *Lank*, reiterated and emphasized in *Arneil* v. *Ramsey*, 550 F.2d 774 (2d Cir. 1977), was that the interests of exchange members and customers tended to be antagonistic insofar as the broker's dealings with an exchange were concerned; if an exchange were

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cited by Touche Ross (Touche Ross Brief 57). *See also* Rosenfeld v. Continental Building Operating Co., 135 F. Supp. 465, 467-68 (W.D. Mo. 1955), for a recognition of a bailee's right to sue for the benefit of bailors, or bailors' insurers, as quasi-trustee.

exposed to potential liability to its members it might become more concerned with placating brokers than with protecting customers. The same antagonism between the interests of tender offerees and the corporate entities engaged in making or resisting a tender offer was recognized by the Supreme Court in *Piper*. 430 U.S. at 39-40.

These considerations do not apply to suits against accountants under Rule 17a-5. Both brokers and customers benefit from proper performance of the Rule 17a-5 requirements. Customer protection would be enhanced, and the type of derelictions that occurred here might be prevented, if the accountant perceived the broker as potential adversary as well as client.

D. There Is Pendent Jurisdiction Over the Trustee's Five Non-Federal Claims Since Those Claims Involve the Same Facts, and Should Be Tried at the Same Time, as the Parties' Federal Claims.

The mandates of "judicial economy, convenience and fairness to litigants" dictate that since there is exclusive federal jurisdiction over the Trustee's federal securities claims—asserted by the Trustee in the shoes of Weis' customers as well as in Weis' own shoes—pendent federal jurisdiction over the Trustee's other claims should also be exercised, so that all outstanding issues revolving around the "common nucleus of operative facts" will be resolved in the same forum. *See United Mine Workers* v. *Gibbs*, 383 U.S. 715 (1966). For reasons discussed in connection with the argument that this action be stayed (pages 23-25, *infra*), the Trustee is frankly baffled by Touche Ross' insistence that judicial economy, convenience and fairness would be served by requiring the simultaneous prosecution of a separate, partially overlapping State court proceeding.

II.

The District Court Had the Same Plenary Jurisdiction Over the Trustee's Claims as a Chapter X Court or a Court Supervising a Federal Equity Receivership.

A. The District Court Had the Plenary Jurisdiction of a Chapter X Court.

As discussed in our original brief (Trustee's Brief at 28-35), the most explicit jurisdictional provisions in SIPA are Sections 5(b)(2) and 6(b)(1). (15 U.S.C. §§78eee(b)(2) and fff(b)(1).) In Section 5(b)(2), Congress expressly conferred upon the district court supervising a SIPA liquidation both the same exclusive summary jurisdiction over the debtor and its property enjoyed by bankruptcy and Chapter X courts and the full "power" of a Chapter X court as well as a court supervising a Chapter I-VII bankruptcy. The "power" referred to is the full range of "power" conferred on district courts under the bankruptcy clause by Congress in Section 2 of the Bankruptcy Act (11 U.S.C. §11), including the plenary jurisdictional "power" conferred by Section 2a(7) and exercised in actions brought by Chapter X trustees. In Section 6(b)(1) Congress augmented and reinforced that grant of "power" to the district court by providing a SIPA trustee with all the powers of both a bankruptcy and a Chapter X trustee. *See SEC* v. *Albert & Maguire Securities Co.*, [Current] Fed. Sec. L. Rep. (CCH) ¶96,129 (3d Cir. 1977); 3 W. Collier, *Bankruptcy* ¶60.85[2] at 1247 (14th ed. 1976).

In its responsive brief, Touche Ross argues (at 69-86) that Congress did not confer Chapter X jurisdiction on the district court supervising a SIPA liquidation but left it with exactly the same plenary jurisdiction as a district court supervising a conventional Chapter I through VII bankruptcy. This argument is based on two erroneous premises: first, that Section 6(c)(1) of SIPA overrides the more explicit jurisdictional provisions in SIPA; and second, that Sections 5(b)(2) and 6(b)(1) of SIPA con-

fer summary but not plenary jurisdiction on the district courts.

First, Section 6(c)(1) is plainly not a provision which is intended to define the plenary jurisdiction of the district courts. It deals with the conduct of the "liquidation proceeding" in the bankruptcy court and before the bankruptcy judge. This "liquidation proceeding" is that referred to in Section 6(a) of SIPA, 15 U.S.C. § 78fff(a), and involves the exercise of summary jurisdiction over such things as administrative orders, resolution of claims and distribution of property. The conduct of a "liquidation proceeding" has nothing to do with the extent of the district court's plenary jurisdiction over suits maintained by the trustee outside of the "liquidation proceeding." That jurisdiction is conferred by Section 5(b)(2) of SIPA.

The indirect reference to Section 23 in Section 6(c)(1) of SIPA can only apply to the extent that it is not "inconsistent" with Section 5(b)(2)[5] and must thus be read as having been intended to clarify the extent of the summary jurisdiction and remedial powers of the bankruptcy court. Despite the broader potential jurisdiction over actions involving the trustee made available to the district court in Section 5(b)(2), the summary jurisdiction and functions of the Bankruptcy Judge are to remain in general the same as in bankruptcy so that the "liquidation proceeding" will be conducted "as though" it were a bankruptcy. That is precisely what Bankruptcy Judge Babitt held in *SEC* v. *Morgan Kennedy & Co.*, [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,568 (S.D.N.Y. 1974), the case so heavily relied upon by Touche Ross. (Touche Ross Brief at 72, 73, 77, 82.) Neither that case nor any other has held that Section 6(c)(1) prevented the district court in which the SIPA "liquidation proceeding" was filed from exercising its Chapter X plenary jurisdiction over an independent action by the Trustee.

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[5] Section 6(c)(1) specifies that the provisions of Chapters I through VII and Chapter X apply "[e]xcept as inconsistent with the provisions of this chapter."

The second prong of Touche Ross' argument—that Section 5(b)(2) confers summary but not plenary jurisdiction on the district court where a SIPA liquidation proceeding is pending—is even less persuasive. Touche Ross focuses on language conferring on the SIPA court "exclusive jurisdiction of the debtor involved and its property wherever located." Touche Ross then spends five pages (Touche Ross Brief at 79-83) arguing what no one has ever disputed: that a grant of "exclusive jurisdiction over the debtor and its property" is generally interpreted as a grant of summary jurisdiction, not plenary jurisdiction over claims against third parties. This argument is a textbook example of the creation and destruction of a strawman, for the Trustee has never suggested that the "exclusive jurisdiction" language of Section 5(b)(2) provides the predicate for the exercise of Chapter X plenary jurisdiction over claims by the Trustee against third parties.

Rather, it was by providing the SIPA court in Section 5(b)(2) with the "power" of a Chapter X court, that Congress conferred the full plenary jurisdiction of a Chapter X court in addition to exclusive summary jurisdiction over the debtor and its property. "Power" is a jurisdictional word. It is *the* quintessentially jurisdictional word. Article III of the Constitution speaks of "Judicial Power". The cases cited at page 29 of our original brief equate "power" with "jurisdiction." In *Williams* v. *Austrian*, 331 U.S. 642, 659-60 n.45 (1947), the Supreme Court noted that the "powers" provision in Section 115 of the Bankruptcy Act "has been interpreted as jurisdictional" by the federal courts. And Section 2(b) of the Bankruptcy Act refers to the "jurisdiction" vested in courts of bankruptcy by the various subsections of Section 2a—including the plenary jurisdiction created by Section 2a(7)—as "powers."

In fact, when Touche Ross attempts to explain what purpose the reference to "powers" of a Chapter X court serves in Section 5(b)(2) if the word refers to remedies, not jurisdiction, it is unable to articulate any possible meaning to the term and is forced to conclude that it is "surplusage."

(Touche Ross Brief at 82-83 n.65.)[6] It is hornbook law that when statutory language can be read in one of two ways, one of which has meaning and one of which has none, the former is to be preferred. *E.g., Platt* v. *Union Pacific R.R. Co.*, 99 U.S. 48, 58-59 (1879); E. Crawford, *The Construction of Statutes* §§ 165 at 200, 200 at 348 (1940). Here, under Touche Ross' own analysis the reference to Chapter X "power" in Section 5(b)(2) has meaning only if "power" means jurisdiction over plenary actions by a SIPA trustee.

B. The District Court Had the Same Ancillary Jurisdiction of the Trustee's Claims as a Federal Court Supervising an Equity Receivership Under Section 115 of the Bankruptcy Act.

It is illogical to read Section 6(c)(1) as if it has anything to do with plenary jurisdiction. But even if Section 6(c)(1) is subjected to such a reading, it does not say what could have been said in very few words indeed: that the District Court supervising a SIPA liquidation has no greater jurisdiction than a District Court supervising a Chapter I through VII bankruptcy. Rather, Section 6(c)(1) says something quite different: it incorporates all the provisions of Chapter X and all the provisions of Chapters I through VII referred to in Section 102 and commands that they be read consistently with one another and with the other provisions of SIPA.

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[6] To support its argument that this and other references to Chapter X are "superfluous" (Touche Ross Brief at 78 n.53, 84 n.61) and should be ignored, Touche Ross cites the SIPC Task Force Report which unsuccessfully suggested amending SIPA in order to clarify which provisions of Chapters I-VII and X of the Bankruptcy Act were intended to be incorporated by SIPA. The concern in that report appears, however, to have been with the conduct of the liquidation proceedings, not jurisdiction over plenary actions involving the Trustee. In any case, as the Second Circuit recognized in *Exchange Nat'l Bank* v. *Wyatt*, 517 F.2d 453, 457 n.8 (2d Cir. 1975), the report is hardly probative of Congress' intention in drafting the original statute.

Included among the jurisdictional provisions of Chapter X incorporated into SIPA Section 6(c)(1) is not only Section 2a(7) of the Bankruptcy Act but also Section 115—a provision which grants a court supervising a Chapter X liquidation the full ancillary jurisdiction of a federal court supervising an equity receivership. Section 23, referred to indirectly in Section 6(c)(1), operates to supersede Section 2a(7) insofar as that section would extend Chapter X jurisdiction to all United States District Courts; SIPA proceedings are liquidations, not rehabilitations, and there would be no reason for Congress to create nationwide jurisdiction. Section 23 also operates, as in normal bankruptcy, to define the summary jurisdiction of the District Court over the debtor's property and controverted claims. But Section 23 cannot have been intended to supersede the ancillary jurisdiction over actions by the Trustee conferred on the "home court" by Section 115. Such a reading of the Chapter X provisions incorporated in SIPA is unnecessarily inharmonious for reasons discussed at pages 31-33 of our original brief and would be completely inconsistent with the explicit grant of plenary jurisdiction to the home court in Section 5(b)(2).

Touche Ross argues that Section 115 is not a jurisdictional provision but confers only remedial powers on the District Court. (Touche Ross Brief at 86-89). As the Supreme Court noted in *Williams* v. *Austrian*, *supra*, 331 U.S. at 659-60 n.45, however, Section 115 has been accepted as jurisdictional in every case which has either implicitly or explicitly dealt with the question of its jurisdictional aspect.[7] The cases are cited at pages 33-34 of our original

[7] The cases cited by Touche Ross (at 88-89 n.65) indicating that the "powers" language has been interpreted to include substantive powers over property exercised by a court of equity do not articulate a contrary rule. The broad grant of equity powers contained in Section 115 is not inconsistent with the fact that it, like Section 2 of the Bankruptcy Act, is both a jurisdictional and remedial provision. None of the Section 115 cases cited by Touche Ross holds or even implies that Section 115 is not a jurisdictional grant.

brief. The principal spokesman for the final version of Section 102 himself regarded Section 115 and its predecessor, Section 77B(a), as jurisdictional provisions. *See* 2 J. Gerdes, *Corporate Reorganizations* § 908 at 1473 (1936).

Touche Ross' argument regarding the jurisdictional effect of Section 115 (Touche Ross Brief at 86-88) is based primarily upon case law arising under former Section 77B of the Bankruptcy Act, the predecessor to Chapter X, and the erroneous assumption that "decisions interpreting [former] Section 77B(a) are applicable to Section 115." (Touche Ross Brief at 87 n.64). However, these decisions were not based on Section 115 as it now stands; they involved the different configuration of provisions which appeared as part of Section 77B, but which do not appear in Section 115. Thus, while subsection (a) of Section 77B provided, in a manner similar to Section 115, that the court

> "shall have and may exercise all the powers, not inconsistent with this section, which a Federal Court would have had if it appointed a receiver in equity of the property of the debtor by reason of its inability to pay its debts as they mature," [8]

a further subsection of 77B—subsection (*o*)—modified the jurisdictional reach of subsection (a) by expressly providing:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court * * * shall be the same *as if a voluntary petition for adjudication had been filed* and a decree of adjudication had been entered on the day when the debtor's petition or answer was approved." [9] (Emphasis added.)

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[8] Act of June 7, 1934, Pub. L. No. 73-296, § 77B(a), 48 Stat. at 912 (1934).

[9] *Id.*, § 77B(*o*), 48 Stat. at 922.

The interplay of subsection (*o*) with subsection (a) was the dispositive factor in the cases such as *In re Prudence Bonds Corp.*, 75 F.2d 262 (2d Cir. 1935), relied on by Touche Ross.[10] There is, however, no counterpart to subsection (*o*) in Section 115.

A SIPA liquidation is a quasi-bankruptcy. It involves some elements of a traditional bankruptcy, some elements of a corporate reorganization and some special provisions based on the nature of the securities industry. The entire proceeding is animated by a Congressional concern for the most prompt and complete closing of transactions, marshalling of assets and distributions of property to customers. The district court presiding over a SIPA liquidation proceeding has a duty to see that these Congressional purposes are achieved. It should not lightly be assumed that Congress intended to put limits on the court's jurisdiction which would impede its discharge of this duty. Recognition that the federal court supervising a liquidation should have a jurisdiction commensurate with its duties led the Supreme Court to uphold the "home court's" ancillary jurisdiction over suits by federal equity receivers in the first place. *White* v. *Ewing*, 159 U.S. 36 (1895); *Pope* v. *Louisville, New Albany & Chicago R. Co.*, 173 U.S. 573 (1899).

While the full jurisdictional provisions of Chapter X would not be necessary in SIPA, home court jurisdiction would be particularly desirable. Such jurisdiction would

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[10] As the *Prudence Bonds* court stated:

> "[i]t is clear both from *the language used in these subdivisions* [77B(a) and 77B(*o*)], and from the consequences of a contrary ruling, that Congress did not intend the bankruptcy court in proceedings under section 77B to take over all litigation between the debtor and third persons." (*Id.* at 263; emphasis added.)

See also United States v. *Tacoma Oriental S. S. Co.*, 86 F.2d 363, 368 (9th Cir. 1936); *In re Standard Gas & Electric Co.*, 119 F.2d 658 (3d Cir. 1941); *In re Prima Co.*, 98 F.2d 952 (7th Cir. 1938), *cert. denied*, 305 U.S. 658 (1939) (all cases relied upon by Touche Ross but all based on the interplay of subsections (a) and (*o*) of old section 77B).

avoid piecemeal and unnecessarily protracted litigation when, as might often be the case, exclusive jurisdiction would lie in the federal courts over some participants but not others[11] in closely related transactions. Home court jurisdiction would also provide prompt resolution of actions to recover fund property (such as excess hypothecated margin securities) held by local banks which may assert adverse claims sufficiently colorable to be beyond the summary jurisdiction of the Bankruptcy Judge. In any event, home court jurisdiction is the jurisdiction Congress chose to confer in Section 5(b)(2) of the Act. Nothing in Section 6(c)(1) detracts from that jurisdictional grant.

III.

The District Court Had Summary Jurisdiction Over the Trustee's Claims.

Touche Ross concedes that even under its grudging interpretation of the jurisdictional provisions of SIPA, the District Court had at least the same summary jurisdiction as a court supervising an ordinary bankruptcy. That summary jurisdiction is sufficient to support this action because the claims asserted by the Trustee are related to two proofs of claim filed by Touche Ross in the Weis liquidation proceeding.

At pages 97-100 of its brief, Touche Ross seeks to avoid the adverse exercise of the very jurisdiction it invoked in behalf of its claims by citing numerous cases decided by courts other than this Court. Those cases hold on sometimes obscure rationales that the consent to jurisdiction

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[11] For example, many elements of a section 17 action which Touche Ross claims are not satisfied here would presumably be satisfied in an action against the Weis Five. Were they viable defendants, it would make little sense not to be able to litigate all claims based on false reports and the audit as of May 26, 1972 in one court, particularly the court having some familiarity with the SIPA liquidation.

to be implied from the invocation of the jurisdiction of a Court of Bankruptcy is limited to "closely related" claims or claims in the nature of "compulsory counterclaims". As demonstrated at pages 36-42 of our original brief, the Trustee's claims are sufficiently related to the claims of Touche Ross to meet the tests for compulsory counterclaims enunciated in cases previously decided by this Court. All that is required is a showing of "logical relationship;" that sort of nexus is self-evident here. Both sets of claims arose out of Touche Ross' ongoing role as Weis' accountants; evidence relevant to Touche Ross' claims will be relevant to the Trustee's claims; and Touche Ross' claims involve work done with respect to the very false entries which the Trustee alleges Touche Ross failed to detect in 1972.

It is far from clear, in any event, that any standard other than the "mutuality"[12] required for a set-off pursuant to Section 68 of the Bankruptcy Act, 11 U.S.C. § 108, should be applied in determining the appropriateness of adjudicating the Trustee's claims. *Cherno* v. *Engine Air Service, Inc.*, 330 F.2d 191, 193 (2d Cir. 1964). In *Katchen* v. *Landy*, 382 U.S. 323 (1966), the Supreme Court held that summary jurisdiction existed to decide whether a claimant had received a preference because that determination was a prerequisite to determining the size and allowability of the creditor's claim. The Court then held that, since such a determination would be *res judicata* in any later plenary suit to recover the preference brought by the Trustee, "it can hardly be doubted that there is also summary juris-

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[12] Claims are "mutual" within the meaning of § 68 if they are "in the same right and between the same parties, standing in the same capacity." 4 W. Collier, *Bankruptcy* ¶ 68.04 at 867 (14th ed. 1975); United States v. Roth, 164 F.2d 575, 578 (2d Cir. 1948). In the instant case, the Trustee's claims seek recovery against Touche Ross for wrongs suffered by Weis prior to the commencement of the Weis liquidation. Both Touche Ross claims likewise involve services performed for Weis prior to the commencement of the Weis liquidation.

diction to order the return of the preference." 382 U.S. at 334.

The same rationale should apply to any "mutual debts" since such debts must be set off under Section 68 and "the balance only . . . allowed or paid." There is no doubt that, once Touche Ross filed its proofs of claim, summary jurisdiction existed to adjudicate any mutual claim, even a wholly unrelated claim, as a set-off which would diminish or defeat the claims of Touche Ross. *Conway* v. *Union Bank of Switzerland*, 204 F.2d 603, 607 (2d Cir. 1953); *United States* v. *Roth*, 164 F.2d 575, 578 (2d Cir. 1948); 4 W. Collier, *Bankruptcy* ¶ 68.20[4] at 946 (14th ed. 1975). *See* 3 *Moore's Federal Practice* ¶ 13.19[1] (2d ed. 1974). Once adjudicated between the parties, any decision as to the validity and amount of the claim raised by the trustee as a set-off would be *res judicata* in any later action brought by the trustee. *Conway* v. *Union Bank of Switzerland*, *supra*, 204 F.2d at 607; *Schwartz* v. *Levine & Malin, Inc.*, 111 F.2d 81 (2d Cir. 1940). Thus the principle of *Katchen* v. *Landy* should extend not only to preferences but to any mutual claim capable of being set-off under Section 68. There is not even a serious question of summary jurisdiction here, where both "mutuality" and logical relationship exist.

That the Trustee invoked the summary jurisdiction of the bankruptcy court directly rather than proceeding before the Bankruptcy Judge is of no moment. It is the District Court that is given summary jurisdiction under Section 2 of the Bankruptcy Act and Section 5(b)(2) of SIPA. Even in a normal bankruptcy under the recent Bankruptcy Rules—rules not necessarily applicable *in toto* to SIPA liquidations—the disputes within the District Court's summary jurisdiction committed to the Bankruptcy Judge are committed to that official on the theory that the district court retains direct supervisory control through its power of review, a power which is not even subject to a final order rule. *See* Bankruptcy Act §§ 2a(10), 39c, 11

U.S.C. §§ 11(a)(10), 67(c); Bankruptcy Rules 801, 810; 2A W. Collier, *Bankruptcy* ¶ 39.21 (14th ed. 1974).

Here the Trustee merely seeks to proceed in the first instance in the District Court because trial of a case of this scope and complexity before the Bankruptcy Judge would be manifestly inappropriate. Direct proceedings in the District Court were also necessary because the other jurisdictional bases for the Trustee's action could be invoked in the District Court, but not before the Bankruptcy Judge. Touche Ross can point to no prejudice which results from bypassing a totally unnecessary layer of judicial review and to no provision of SIPA (or, for that matter, the Bankruptcy Act) which prevents that layer from being bypassed in a case of this kind. In any event, the remedy for bypassing the Bankruptcy Judge would not be outright dismissal of the complaint but a remand with directions that the Trustee's complaint be consolidated with his objections to Touche Ross' claims before the Bankruptcy Judge.

IV.

This Action Should Not Be Stayed in Favor of the State Court Action.

No compelling reason appears why this Court should deviate from usual appellate procedure by entertaining Touche Ross' request for a stay, a matter which the District Court has never passed upon.[13]

In any event, it seems unspeakably obvious that, as long as at least one plaintiff has a Section 17 claim, the action that should proceed is the federal action, not the state court action. Since the District Court's jurisdiction over

[13] In *Weiner* v. *Shearson, Hammill & Co., Inc.*, 521 F.2d 817 (9th Cir. 1975), a case much relied upon by Touche Ross, the Court of Appeals, after discussing the many factors involved in deciding whether a federal action should be stayed pending the determination of a state court action, remanded the action so that the District Court could consider, in the first instance, whether such a stay was appropriate in that case.

any Exchange Act claim is exclusive under Section 27, the federal action is necessarily the more comprehensive and is the action that should proceed. *See, e.g., Lyons* v. *Westinghouse Electric Corp.*, 222 F.2d 184 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955); *Cotler* v. *Inter-County Orthopaedic Ass'n*, 526 F.2d 537 (3d Cir. 1975).

It is difficult to fathom what possible economies would be served by requiring trial of a negligence action in the state courts and then beginning all over in the federal courts with claims predicated directly on Rule 17a-5. At best, difficult questions of *res judicata* and collateral estoppel effect would only be created if this action were stayed until judgment was reached in the State courts. *See Lewis* v. *Marine Midland Grace Trust Co.*, 63 F.R.D. 39, 52-53 (S.D.N.Y. 1973).

Much of Touche Ross' stay argument is based on the premise that the state court action has assumed some degree of precedence over this one. This premise is a false one. Cases such as *Klein* v. *Walston & Co.*, 432 F.2d 936 (2d Cir. 1970), are simply not in point. As noted at pages 2-3, *supra*, the state court action was commenced, out of an excess of caution, in only the most technical sense and has not progressed significantly. It is the rule in this Circuit that "the determination of priorities between pending [federal and state] cases on the basis of dates of filing is not to be applied in a mechanical way regardless of other considerations." *Telechron, Inc.* v. *Parissi*, 197 F.2d 757, 762 (2d Cir. 1952). *See also Hammett* v. *Warner Brothers Pictures, Inc.*, 176 F.2d 145, 150 (2d Cir. 1949); *Georgia Pacific Corp.* v. *County of Mendocino*, 340 F. Supp. 1061 (N.D. Cal. 1972), *aff'd*, 515 F.2d 283 (9th Cir. 1974).

The lack of progress in the state court action has stemmed from plaintiffs' belief that it is this action which should proceed once the question of subject matter jurisdiction is resolved in plaintiffs' favor. The federal district court is the only place where all the state claims and all

of the federal claims could possibly be tried together. That is the consideration that should control the relative priority of the two actions.

CONCLUSION

For the foregoing reasons, the order of the District Court should be reversed in all respects.

Respectfully submitted,

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STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

AFFIDAVIT
OF SERVICE

CONLEY E. BRIAN, JR., being duly sworn, deposes and says that he resides at 7 East 14th Street, New York, New York 10003; that on the 25th day of October, 1977, he served the within Trustee's Reply Brief of Plaintiff-Appellant, Edward S. Redington, as Trustee for the liquidation of the business of Weis Securities, Inc. on the attorneys for Plaintiff-Appellant, Securities Investor Protection Corporation, Defendant-Appellee, Touche Ross & Co., and amicus curiae, Securities and Exchange Commission herein by mailing two true copies thereof, securely enclosed in a post-paid, properly addressed wrapper, in the mail box under the exclusive care and custody of the United States Postal Service at the corner of Wall Street and Broadway, New York, New York, addressed to said attorneys as follows:

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The above addresses have appeared on the prior papers in this action as the office addresses of said attorneys.

Deponent is over the age of 18 years and not a party to this action.

Conley E. Brian, Jr.

Sworn to before me this
25th day of October, 1977.

Notary Public
SUSAN M. RESTI
Notary Public, State of New York